

Monthly Economic & Investment Market Commentary

October 2019

For the calendar year to date, the S&P/ASX200 index which tracks the Australian share market has provided a very impressive total return of a little more than 26%. However, just about the entirety of that return came in the year to July, and we have tracked largely sideways in the more than three months subsequent to that. This is of course, the nature of risky investment markets such as equities and should serve as a reminder that whilst we forecast long-term per annum returns, we do not expect that returns will arrive in anything close to a consistent or uniform manner.

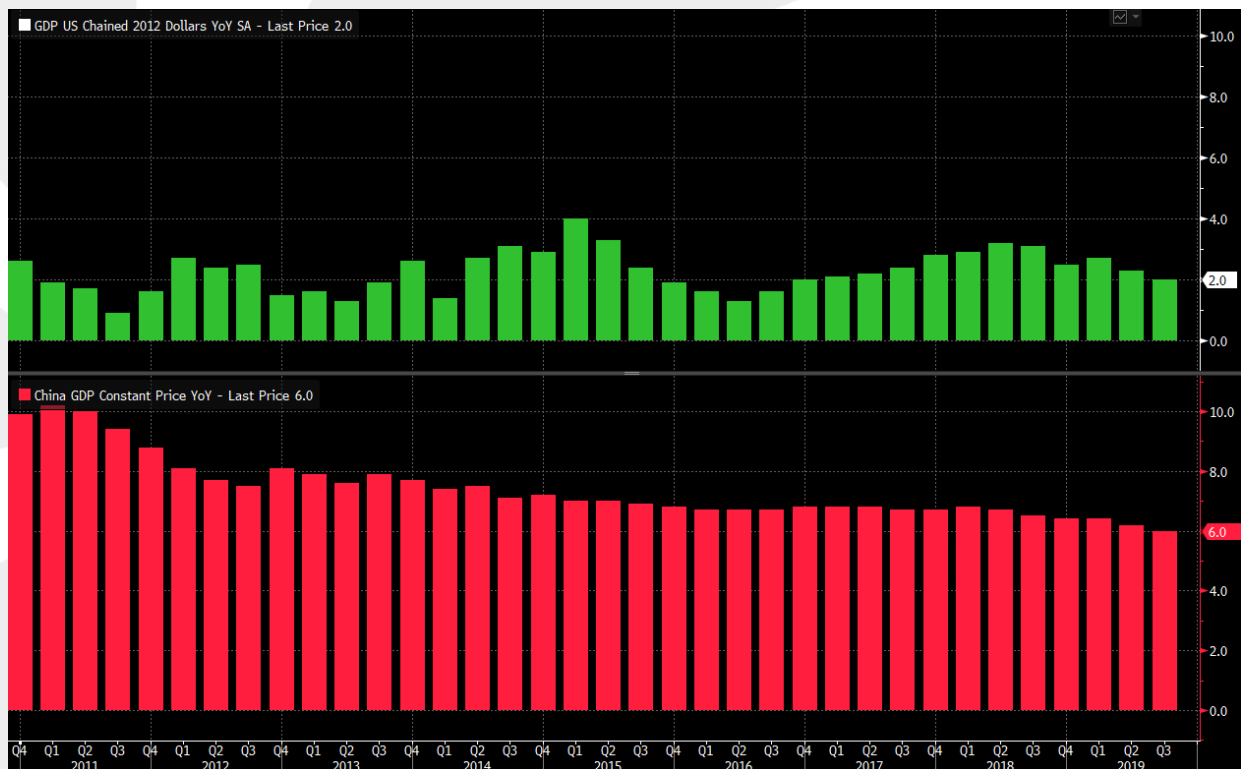


US – CHINA TRADE WARS

If you've been following along in the weekly commentaries, you will know that sentiment in global equity markets has been changing from one week to the next. The pattern has been that first there are reports that significant progress is being made on resolving the trade dispute between China and the United States. This leads to some sense of optimism – or at least the prospect of removing a negative – and the market pushes further upward. Then typically within a day or two, and most often emanating from the US President's interviews or tweets, it becomes apparent that the sides remain some way off agreement, even on reaching the limited so-called 'Phase One' deal. At this point the market retraces, at least in part, the earlier gains.

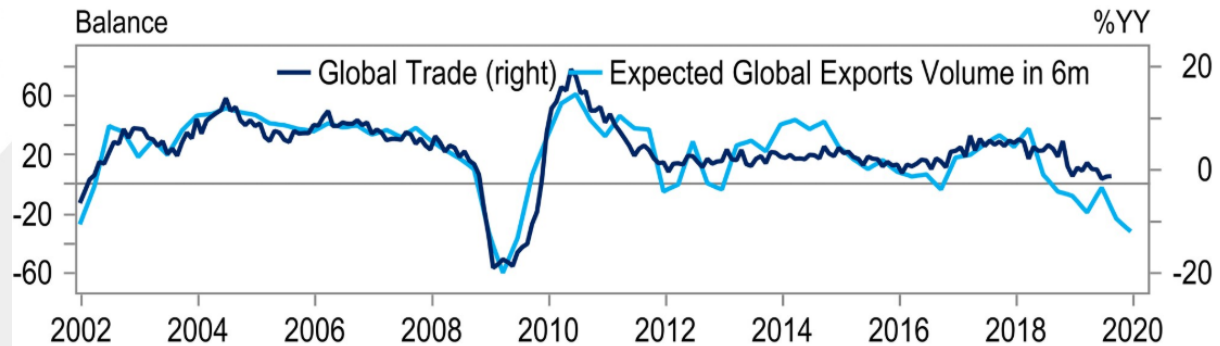
Of particular note lately, were suggestions that this early initial deal would mean not just a cessation on imposing further tariffs on trade, but also that there would be a start made on repealing those levies already in place. It is not hard to see how such talk upset President Trump, who likely perceived it as a sign of weakness, which in turn led to this response: “China very much wants to make a deal, they’re having the worst year they’ve had in 57 years. Their supply chain is all broken, like an egg, they want to make a deal, perhaps they have to make a deal, I don’t know, I don’t care, that’s up to them.”¹

Likely the President’s supporters will dismiss the ‘don’t know, don’t care’ statement as bombastic rather than literal, but it does perhaps at least partly illustrate why the negotiations to date have been so fraught. As President Trump says, China’s rate of economic growth has indeed slowed, though as the chart below shows it is currently still growing at 3x the rate of the US economy. The data for the year ended September 2019 has the annualised rate of GDP growth at 6% in China and 2% in America. Importantly, current estimates prepared by two separate federal reserve district banks are predicting especially weak Q4 annualised growth for the United States.

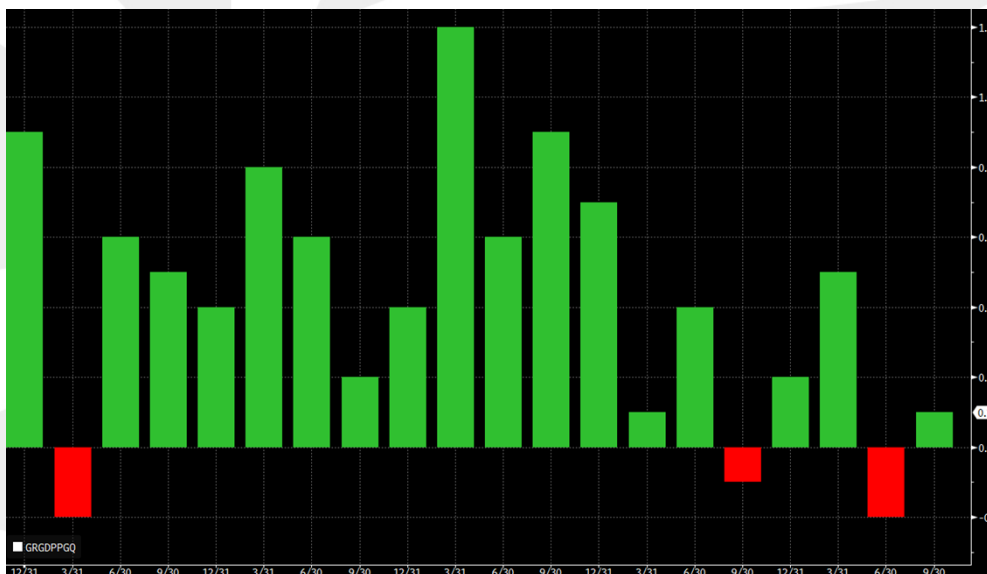


That said, we expect the Chinese GDP number will continue to slow and at some point in the near future it will start with a 5. When that happens, you most assuredly will see the same headlines that we read every quarter about how this represents the slowest rate of growth in decades. Whilst that is factually accurate, it is also quite misleading in terms of describing the relative health of the Chinese economy. No one should reasonably expect that the double-digit growth that China delivered a decade and more ago, when they were a much smaller economy, is possible or even desirable for what has been the world’s second largest economy since 2010.

For now at least, amidst the ongoing uncertainty, major investment decisions are continuing to be delayed, and global trade is still slowing which is having a flow on impact to world economic growth. As the lighter blue line in the chart² below shows, currently expectations are that the next six months will see the situation deteriorate further. However, that likely reflects at least some degree of conservative pragmatism and presumably would improve quite quickly on the eventuality of a trade deal actually being signed.



EUROPE



Whilst the main protagonists in the aforementioned trade war are certainly starting to reflect the negative impact of the dispute in their economic growth, Europe and particularly Germany have also felt the brunt of the trade slowdown. In fact, with a much larger proportion of their economy export focused, Germany has arguably been adversely affected to a greater extent than either China or the United States. It was in fact widely anticipated that the Germans would report a second

consecutive quarter of economic contraction when the Q3 data was released. As this chart shows, they did narrowly avoid meeting that widely accepted definition of an economic recession by virtue of the +0.1% growth shown on the far right.

Whilst this is a welcome development, it should not be taken as implying that growth starts trending higher from here, again, especially while the trade uncertainty remains. Indeed, current consensus forecasts have the German economy growing at +0.7% and +1.2% for 2020 and 2021 respectively.

This situation has led many observers to question why the German government is not doing more to provide stimulus in an attempt to boost such meagre growth rates. The answer lies in a policy that was ratified in the aftermath of the financial crisis of a decade ago, known as *Schwarze Null*, or Black Zero. The policy was actually

included in Germany's constitution in 2009 and forbids the 16 regions from running any fiscal deficits, and tightly restrains the ability of the federal government to do so.

It is especially perplexing as to why the policy is being steadfastly adhered to by Angela Merkel and her government at a time when the world will actually pay for the privilege of lending money to Germany. At time of writing, the interest rate payable on German bunds is negative at all maturities out to 15 years, and beyond that lenders are willing to accept a return of just 0.175% per annum to buy 30-year German government debt.

Defying the popular perceptions of German infrastructure, as best exemplified by the famous autobahns, there is in fact a strong case to be made for using very cheap government borrowing to improve transport infrastructure and economic productivity. The head of the German Economic Institute, who was formerly a strong advocate of the constitutional limits on fiscal deficit financed spending, has recently called for the creation of a "Deutschland Fund," which would spend €450 billion over the next decade on climate change measures, digitisation and upgrading the nation's transport facilities.

Whilst support from within government is still muted, there is some evidence that attitudes are changing. The sub-title of a recent article in *Der Spiegel*³ said: "Chancellor Angela Merkel is still clinging to her policy of a balanced budget, but it is becoming increasingly clear that Germany's economic downturn could soon usher in a return to deficit spending. Government ministries are already signaling a willingness to abandon years of cautious fiscal policy." At this stage expectations for fiscal stimulus should be muted, and that is especially the case for the next couple of years whilst Angela Merkel remains as Chancellor. The prospect does however, represent a potentially very important positive catalyst to not just German and European but world economic growth over the medium term.

Whilst we patiently await any such development in terms of fiscal policy, we note that ongoing support from the European Central Bank with respect to monetary policy continues. With policy direction set by the President Mario Draghi in the last stage of his tenure at the ECB, expectations are that new President Christine Lagarde will continue to guide the bank on a steady policy course. Encouragingly, recent survey data has shown that the pessimism in the automobile and steel sectors may have bottomed out, which prompted analysts at Société Générale to note as follows: "A modest economic recovery in Europe in the coming quarters, supported by resilience in private consumption and the services sector along with receding political uncertainty, now seems credible. We therefore expect further upside for European equities in the near term."⁴

The committee continues to monitor developments in overseas economies and financial markets closely. We do however note that there are causes of concern and possibly calamity, and despite this the International Equities asset class has made a strong contribution to portfolio performance over the last several years. That has been aided by a weaker Australian dollar, and the committee continue to actively consider a range of adjustments in the international holdings, as well as the potential to add some currency hedging to protect against a stronger Australian dollar. As always, we will keep you informed of our deliberations and subsequent decisions in these commentaries.

Kind regards,

Asset Allocation & Investment Committee

ASSET CLASS TIPPING POINTS

In line with the comments above about the Australian market tracking sideways for several months, we see little change in the relative valuation of the broader asset class and the financials sector depicted below. Similarly, whilst bond rates have been more volatile, we have not deemed it necessary at this time to further adjust the threshold between Fully Priced and Overpriced. That continues to be set at 2%, representing the expected return on a 5-year term deposit from a major Australian bank over our 10-year forecast period. With a further rally to fresh highs in the first half of November trading, the US equity market has pushed beyond that 2% threshold, and the most recent reading shows it being well into the Overpriced valuation band with an average expected long-term return of just 1.6% per annum. We expect that Japan, Europe and the broader Asia-Pacific region will continue to comprise your International Equities exposures, though as mentioned we are considering some adjustments to the current holdings.

Asset Class Tipping Points - October 2019

Australian Equities				International Equities - Developed				International Equities - Emerging				Listed Property			
All Ords	10 Year Forecast	Valuation	31-Oct	World ExAust	10 Year Forecast	Valuation	31-Oct	Emerging Markets	10 Year Forecast	Valuation	31-Oct	ASX200 Property	10 Year Forecast	Valuation	31-Oct
11,000	1.4%	Overpriced		3,200	1.3%	Overpriced		1,900	1.1%	Overpriced		2,275	1.5%	Overpriced	
10,700	1.7%	Overpriced		3,100	1.6%	Overpriced		1,825	1.5%	Overpriced		2,200	1.9%	Overpriced	
10,400	2.1%	Fully Priced		3,000	2.0%	Fully Priced	← USA 2.0%	1,750	2.0%	Fully Priced		2,125	2.3%	Fully Priced	
10,100	2.5%	Fully Priced		2,900	2.4%	Fully Priced		1,675	2.5%	Fully Priced		2,050	2.8%	Fully Priced	
9,800	2.9%	Fully Priced		2,800	2.8%	Fully Priced		1,600	3.0%	Fully Priced		1,975	3.3%	Fully Priced	
9,500	3.3%	Fully Priced		2,700	3.2%	Fully Priced		1,525	3.6%	Fully Priced		1,900	3.8%	Fully Priced	
9,200	3.8%	Fully Priced		2,600	3.7%	Fully Priced		1,450	4.2%	Fully Priced		1,825	4.4%	Fully Priced	
8,900	4.3%	Fully Priced		2,500	4.2%	Fully Priced		1,375	4.8%	Fair Value		1,750	5.0%	Fair Value	
8,600	4.8%	Fair Value		2,400	4.7%	Fair Value		1,300	5.5%	Fair Value		1,675	5.6%	Fair Value	
8,300	5.3%	Fair Value		2,300	5.2%	Fair Value	← Dev 5.5%	1,225	6.2%	Fair Value		1,600	6.2%	Fair Value	← A-REITs 6.0%
8,000	5.8%	Fair Value		2,200	5.7%	Fair Value		1,150	7.0%	Cheap		1,525	6.9%	Fair Value	
7,700	6.4%	Fair Value		2,100	6.3%	Fair Value		1,075	7.9%	Cheap		1,450	7.7%	Cheap	
7,400	7.0%	Cheap		2,000	6.9%	Fair Value		1,000	8.8%	Cheap	← Emrg 8.3% A-Pac 8.3%	1,375	8.5%	Cheap	
7,100	7.7%	Cheap		1,900	7.6%	Cheap	← Euro 7.9% Japan 8.0%	925	9.9%	Cheap		1,300	9.4%	Cheap	
6,800	8.4%	Cheap	← Aust 8.4%	1,800	8.3%	Cheap		850	11.0%	Cheap		1,225	10.3%	Cheap	
6,500	9.1%	Cheap		1,700	9.0%	Cheap		775	12.3%	Cheap		1,150	11.4%	Cheap	
6,200	9.9%	Cheap	← Fin'l 9.8%	1,600	9.9%	Cheap		700	13.8%	Cheap		1,075	12.5%	Cheap	
Income	6.1%	p.a.		Income*	2.5%	p.a.		Income*	0.0%	p.a.		Income	4.5%	p.a.	
Earnings	2.6%	p.a.		Earnings	2.9%	p.a.		Earnings	7.1%	p.a.		Dist Grwth	2.3%	p.a.	
Valuation	-0.3%	p.a.		Valuation	0.1%	p.a.		Valuation	1.2%	p.a.		Valuation	-0.8%	p.a.	
Forecast	8.4%	p.a.		Forecast	5.5%	p.a.		Forecast	8.3%	p.a.		Forecast	6.0%	p.a.	

* Income for International Equities includes dividends and forecast currency impact.

Sources

- 1: "Trump says China trade talks moving along nicely, but deal has to be right" – Reuters.com. 10-Nov-19.
- 2: D Peterson, et. al. "Markets, Economies Rise and Fall on Global Trade" – Citi Research. 14-Nov-19.
- 3: C Reiermann, "Germany May Abandon Its Beloved Black Zero" – Spiegel Online. 22-Aug-19.
- 4: Lyxor Cross Asset Research, "Turning Point" – SG Securities (HK). 18-Nov-19.

NOTE: It is important to note that each portfolio is managed to its own mandate, which can mean that activity mentioned above is not reflected in your own portfolio. This may be because it is more beneficial to your portfolios after tax performance to complete the trading at a different time, or may be due to individual customisation that you have requested. This flexibility is an integral part of the investment process. If you would like to discuss the tailoring of your portfolio, please contact your Adviser.

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